Tunneling and Propping up by way of Related Party Transactions: An Examination of Financial Performance and Corporate Governance Practices of Selected Companies in India

Synopsis of the PhD thesis Submitted to Mangalore University

Submitted by
Abdul Rasheed P.C
Research Scholar
(Reg.No.MU/EXB/Ph.D/CR.115/Com/2017-18/E.13)
Department of Commerce
Mangalore University, Mangalagangothri-574199
Mangalore, Karnataka

Research supervisor
Dr.T.Mallikarjunappa
Professor
Department of Business Administration
Mangalore University, Mangalagangothri-574199
Mangalore, Karnataka

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1. Introduction

A corporate entity is a legal citizen separated from its founders. The untying feature of a corporate entity towards its founders and other stakeholders gives corporation as the most common form of commercial entity around the world. But this separation creates agency conflicts between the shareholders and managers. The efficient functioning of an entity depends upon the governance system, the structure of the organization and decision-making process. A weak governance mechanism causes to exercise the opportunistic behavior of the managers, which may lead to the expropriation of the interest of minority shareholders by the controlling shareholders. Related Party Transactions (RPTs) are one of the ways that the controlling shareholders may use to expropriate the interest of minority shareholders. RPTs facilitate propping; propping is the practice transferring of controlling shareholders resources into the firm. The efficiency-enhancing hypothesis says that RPTs increase the operating efficiency of the firm through the creation of the internal market within the corporate groups. Section 188 of companies Act 2013 defined a Related-party transaction (RPT) as “a transaction between two parties who are joined by a special relationship prior to the transaction; the transaction could be a business deal, a single or a series of financial contracts, or an arrangement." The parties involved on the two sides of the deal could be a parent company and its subsidiaries or affiliates, the employees, the principal owners, the directors or the management of the company and the subsidiaries, or members of their immediate families. The opportunistic use of RPTs by the controlling shareholders for their own benefit is one of the major challenges to the regulators. The opportunistic uses of RPTs cause tunneling; Tunneling is an unethical and illegal business practice in which the controlling shareholders or high level insiders direct company assets or future business to themselves for personal gain.

The recent studies show that RPTs prop up firms operating performance by reducing the transaction cost and facilitating the smooth transfer of resources between the affiliates. In the context of emerging economies, RPTs have been found correlated with firm performance (Lee et al., 2016; Srinivasan, 2013; Pazzoli and Venuti, 2013; Jian and Wong, 2010; Lin, Liu and Keng, 2010; Chen, Chen and Chen 2009). The efficiency-enhancing hypothesis says that RPTs increase the efficiency of the firm through the creation of the internal market within corporate groups (El-helaly, 2016). Wong, Kim, and Lo (2015) prove that RPTs helps to enhance firm value through the creation of an internal market within affiliated firms and to fulfill the capital needs within the corporate groups. Downs et al., (2016) prove that corporate does not use RPTs as a tool to tunnel out firm’s resources and Elhelaly (2016) do not support

the argument that RPTs are conducted to mask fraud or tunneling. The laws do not prohibit RPTs because, these are normal business transactions, and within business groups, these transactions facilitate an efficient allocation of resources among affiliated firms with the same group.

In India, most companies report RPTs, but only a few companies have complex RPTs such as transactions which are not in the ordinary course of business, intercompany capital transfer and transactions which are not in arms-length pricing. Srinivasan (2013) find that more than 80 percent of the Indian companies have transactions with their related parties except for their Key Managerial Persons (KMP). The major types RPTs in Indian companies are revenue receipts from related parties, revenue expenses paid for related parties and loans, and deposits to related parties.

The literature proves that RPTs can have the dual effect they are transaction efficiency and conflicts of interests between the controlling and minority shareholders. The conflict of interests hypothesis says that RPTs are harmful to the firm interest because there is a chance for tunneling, which says that the controlling shareholders may use RPTs to tunnel out firm resources for their private benefits (Elklish, 2017; Chen, Cheng, and Xiao, 2011; Cheung et al., 2009; Gordon, Henry, and Palia, (2004). On the other hand, the transaction efficiency hypothesis says that RPTs prop up the efficiency of the firm via reducing the transaction cost and facilitating the resource allocation between the affiliates. So it is relevant to analyze the nature of RPTs and its effect on firm operating performance and market value. In India, there are relatively few studies which measure the transaction efficiency of RPTs and the methods of transactions through which expropriation occur. There are limited studies which measure the impact of RPTs on firm value and performance. Studying RPTs is important for investors to ensure the protection available from self-serving transactions. This study aims to make a detailed analysis on the nature of RPTs, the volume of RPTs, the impact of RPTs on firm performance and the role of ownership and governance mechanism to determine the nature and volume of RPTs.

2. Review of Literature: A Brief

There are empirical and theoretical pieces of evidence which support the transaction efficiency hypothesis of RPTs that RPTs improve firm operating efficiency and market value by reducing the transaction costs and facilitating the transfer of goods and services between affiliated firms. Studies also support the conflict of interest hypothesis of RPTs that controlling shareholders and managers use RPTs as a way to allocate the firm's resources for their interest. Tunneling occurs only via non-operating RPTs and firms providing cash

assistance to related parties reduces their market value (Cheung, Rau, & Stouraitis, 2006). Manipulation of accruals and artificial structuring of operating RPTs are the ways to engage earnings management of Chinese firms during their pre Initial Public Offer (IPO) periods and Operating RPTs are used for manipulation of earnings and the volume of these types of RPTs is very low in pre IPO period(Cheng & Chen, 2007). According to Cheung et al. (2009), the minority shareholders in Chinese publicly listed firms are subject to expropriation through tunneling and also gain propping up via RPTs. According to Aharony, Wang, and Yuan (2010), Chinese listed firms use related party sales for opportunistic earnings management during their pre IPO periods. The comparative analysis of gross profit from related party sales and gross profit from arm's length sales find that all related party sales are the results of price manipulation (Lo, Wong, & Firth, 2010). Market views RPTs similar to non-RPT in terms of its impact on firm value (Utama, Utama, & Yuniasih, 2010). The mere presence of RPTs is not an indication of earnings management practices; only some kinds of RPTs are used for management's opportunistic behavior (Gordon, Henry, & Darius, 2004). Cash flow right of the ultimate controlling shareholders is positively associated with normal RPTs and Product market competition has a moderating effect on the relationship between RPTs and cash flow right of the ultimate controlling shareholders (Chen, Wang, & Li, 2012).

Earnings of firms engaged in related party sales are less informative compared to others, and related party sales violate the arm's length assumption of regular market-based transactions (Wang & Yuan, 2012). The disclosure of RPTs reduces information asymmetry and thus reduces stock price crash risk faced by Indian firms (Selarka & Choudhury, 2015). Firm's value is more likely to be lower than non-affiliated firms when the related party sales exceed related party purchases (Tsai, 2015). There has been a negative relationship between RPTs and disclosure rank, and there has been a positive and meaningful relationship between RPTs and evidence of earnings management (Vakilifard, 2015). According to Huang (2016), Chinese firms increase tunneling through related party loan guarantee responding to the 2008 enterprise income tax reform. The related party loan guarantee is taken as a measure of a firms tunneling for a sample of domestic firms and foreign-invested firms in China. Domestic firms have a high volume of related party loan guarantee compared to foreign-invested firms because of the weak corporate governance and inefficient banking system. Discretionary RPTs increase firms accounting choices and the increase in accounting choices reduce the comparability of financial information (Lee, Kang, Lee, & Park, 2016). RPTs are common business transactions in business groups, and these transactions help corporate groups for efficient resource allocation at low transaction cost (Lo & Wong, 2016). The disclosure of

transfer pricing methods provides value relevant information than the mere disclosure of related party sales (Lo & Wong, 2016). Direct compensation to related parties positively associated with tunneling and transfers of the asset, buying, and selling of goods and services are associated with propping up (Yaron, Uri, & Ahron, 2016). RPTs have a positive impact on real activity manipulations, but the effectiveness of audit committee weakens this relationship (Limanto and Herusetya, 2017). Revenue RPTs are used for managing earnings than any other types of RPTs and RPTs with ultimate parents are associated with the low level of earnings management than other parties (Marchini, Mazza, & Medioli, 2018).

3. Problem Statement:

The literature proves that RPTs have dual effects; transaction efficiency and the expropriation of the interest of minority shareholders by the controlling shareholders. Here the efficient transaction means transactions considered as sound business exchanges and the fulfillment of economic needs which help to prop up firm performance. Expropriation of the interest of minority shareholders arises when controlling shareholders use RPTs to tunnel out the firm's resources for their own benefit. In India, most of the companies have various kinds of business relations with their related parties, and these dealings may be favorable or unfavorable to the value of the firm. So it is relevant to examine the effect of RPTs whether RPTs causes tunneling or they prop up firm performance. The following research questions bring the problem into a sharp focus;

1. What is the nature and size of RPTs in Indian companies?
2. Are the governance and ownership characteristics having an effect on RPTs.?
3. Do RPTs increase operating efficiency?
4. Are RPTs one of the ways used by the insiders to tunnel out firm’s resources for their private benefit?

4. Significance of the Research

Study on the analysis of RPTs is essential in emerging countries, especially in India, where ownership is concentrated, and the corporate governance mechanism is regularly updated. A comprehensive analysis of RPTs helps to identify the nature of RPTs, the frequency of RPTs, and the volume of RPTs. The study helps to understand the impact of RPTs on firm performance. Both accounting-based performance measures and market-based performance measures are used for analysis; which helps to identify whether RPTs in India is abusive or not and also helps to identify the impact of each type of RPTs on firm performance. This analysis helps to identify which type of RPTs supports the efficiency-enhancing hypothesis and which type of RPTs are the results of the expropriation of the minority shareholders by

the controlling shareholders. The interaction effect of the governance and ownership characteristics on the relationship between RPTs and firm performance helps to identify the characteristics of governance and ownership mechanism causes abusive RPTs and role of governance and ownership structure to mitigate the abusive RPTs which facilitate the smooth transfer of goods and services between the affiliated firms. The results of the analysis will be useful for the regulators to understand the role of existing governance mechanism to control the abusive RPTs and also to solve the complexity associated with RPTs. The research also contributes some valuable findings to the earnings management literature. The measurement of earnings management helps to identify the earnings management practices of the select firms and the pattern of earnings manipulations in India. The study analyses the relationship between RPTs and earnings management. The relationship between RPTs and earnings management represents the managers' discretion over the firm; therefore the results will be useful for the regulators to understand whether RPTs are the results of the discretion of the managers over the shareholders.

5. Objectives:

5.1 To make a detailed analysis of the nature and value of RPTs in India.

5.2 To examine the impact of governance characteristics and ownership on the size of RPTs.

5.3 To examine whether RPTs are used for tunneling or propping up.

5.4 To investigate the linkage between RPTs and earnings management.

6. Hypotheses

In this study, we empirically examine the determinants of RPTs, RPTs and firm performance, the interaction effect of governance and ownership on the relationship between RPTs and firm performance, and the relationship between RPTs and earnings management. We developed the following hypotheses for the empirical examination which are listed below.

6.1 Determinants of RPTs:

A high ownership right of the controlling shareholders reduces the motivation level to loot firms resources and which motivate the founders to conduct RPTs to enhance firms operational efficiency (Chee Yoong, Alfan, & Devi, 2015; Chen, Wang, & Li, 2012; Saleh et al., 2013; Tareq, Houqe, van Zijl, Taylor, & Morley, 2017). Based on these pieces of evidence, we developed the following research hypothesis to investigate the association between PH and RPTs.

6.1.1 H_1: There is a positive association between Promoters Holdings (PH) and the size of RPTs.

The institutional holders are able to advise the board for taking decisions and they can constraint boards decisions which are harmful to the firms interest and they are in favor of conducting RPTs which will improve the efficiency of firms operations (Bhattacharya & Graham, 2009; Elyasiani & Jia, 2010; W. Lin & Liu, 2010; Y. R. Lin & Fu, 2017). Based on this literature support, we developed the following research hypothesis.

6.1.2 H_1: There is a positive association between Institutional Holding (IH) and the size of RPTs.

The board characteristics and governance mechanism have an impact on the nature and volume of RPTs (Nekhili & Cherif, 2011: Gallery, Gallery, & Supranowicz, 2008; Gordon, Henry, & Darius, 2004; Kohlbeck & Mayhew, 2004) based on these findings we developed the following research hypothesis to investigate the association between BS and the value of RPTs.

6.1.3 H_1: A board with more number of directors has a positive impact on the size of RPTs.

6.1.4 H_1: The degree of Board Independence (BI) has a negative impact on the volume of RPTs.

6.1.5 H_1: Board Executive (BE) has a positive impact on the volume of RPTs.

6.1.6 H_1: Promoters Directors (PD) has a positive impact on the volume of RPTs.

6.1.7 H_1: CEO-Duality increases the volume of RPTs

6.2 RPTs and firm performance:

RPTs are conventional business transactions conducted for business purposes which reduce the transaction costs and improve firm performance (Downs, Ooi, Wong, & Ong, 2016; El-Helaly, 2016; Hwang & Kim, 2016; Yaron, Uri, & Ahron, 2016). RPTs worsen firm performance If they are used for tunneling and RPTs prop up firm performance if they are efficient than normal transactions. Based on these pieces of evidence, we developed the following research hypothesis to examine the relationship between RPTs and firm performance.

H_1: RPTs have a positive impact on firm performance.

The ownership structure and governance characteristics have a significant interaction effect on the relationship between RPTs and firm performance (Ariff & Hashim, 2013; Chen et al., 2012; Gallery et al., 2008; Lo & Wong, 2016; Nekhili & Cherif, 2011; Sari, Fatimah, & Djajadikerta, 2016). We developed the following research hypotheses for empirical analysis to measure the interaction effect of ownership and governance characteristics on the relationship between RPTs and firm performance.

6.2.1 H_1: New RPTs Regulations (REG) has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.2 H_1: PH has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.3 H_1: IH has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.4 H_1: Board Size (BS) has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.5 H_1: BI has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.6 H_1: BE has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.7 H_1: PD has a positive interaction effect on the relationship between RPTs and firm performance.

6.2.8 H_1: Duality has a positive interaction effect on the relationship between RPTs and firm performance.

6.3 Impact of RPTs on earnings management practices

There are empirical and theoretical pieces of evidence of the association between RPTs and earnings management. Firms use RPTs to manage their reported earnings and group controlled firms use RPTs to prop up their earnings (Jian & Wong, 2010; Daie & Hasnan, 2012; Munir, Saleh, Jaffar, & Yatim, 2013; Pozzoli, Venuti, & Parthenope, 2014; Vakilifard, 2015).

6.3.1 H_1: RPTs have a positive impact on earnings management.

6.3.2 H_1: Total Revenue Receipts (TRR) has a positive impact on earnings management.

6.3.3 H_1: Total Revenue Expenses (TRE) has a positive impact on earnings management.

6.3.4 H_1: Capital Receipts from Related Parties (CRRP) has a positive impact on earnings management.

6.3.5 H_1: Capital Payments to Related Parties (CPRP) has a positive impact on earnings management.

6.3.6 H_1: Related Party Borrowing (RPB) has a positive impact on earnings management.

6.3.7 H_1: Loans and Advance to Related Parties (LARP) has a positive impact on earnings management.

7. The Scope of the Study

This study investigates and analyzes RPTs in India, determinants of RPTs, the relationship between RPTs and firm performance, and the relationship between RPTs and earnings management. The analysis is based on a sample of 2002 companies listed in BSE, and the selected companies are also grouped into group affiliated firms and standalone firms. To examine the magnitude of RPTs in various industries, the selected companies are again grouped into manufacturing firms and service firms.

In this study we consider the total amount of RPTs with all the related parties reported in the financial statement for the empirical analysis and RPTs with different parties such as associate companies, holding companies, KMP, relatives of KMPs, parties where control exists and other parties used for descriptive analysis. Associate companies, holding companies, KMPs, relatives of KMPs, parties where control exists are the major related parties in India based on the number of RPTs. We also examine the impact of each type of RPTs on firm performance; for this analysis, we consider Related Party Sales (RPS), Related Party Services (RPSS), Operating Income from Related Parties (RPOPR), Related Party Purchases (RPP), Related Party Revenue Expenses (RPRE), CRRP, CPRP, LARP, and RPB, we chose these types of RPTs based on the volume and frequency of the transactions. For the empirical examination of the determinants of RPTs, we consider two measures of RPTs such as total amount of RPTs and RPTs with non-subsidiaries. The reason for this classification is that the chance for discretionary RPTs with subsidiaries is very low compared to RPTs with other parties because the effect of the transaction between the parent firm and the wholly owned subsidiary firms disappear while consolidating the books of accounts. The study also examines the relationship between RPTs and earnings management, for this empirical examination the sum of RPS, RPSS, and RPOPR are considered as TRR, and the sum of RPP and RPRE are considered as TRE. We assume that the effect of all types of operating receipts and operating expenses have a similar impact on earnings management. This study does not include banking and financial companies because of their specific nature of financial reporting, and there are differences in the governance measures of financial companies and the non-financial companies.

8. Research Methodology

8.1 Sample selection:

The study aims to analyze RPTs in India. Our sampling procedure is based on listed companies, because the listing agreements of SEBI and other market regulatory measures are

applicable to only listed firms and their financial data are publicly available. We selected all the companies which are listed in Bombay Stock Exchange (BSE) as on 31st March 2016, and their financial data is available in the Prowess database. There are 5308 BSE listed companies on 31st March 2016 their data is available in the Prowess database. We exclude banking and financial companies from our sample because of their unique reporting style, and companies they have missing observations of the study variables are also excluded. The final sample is 2002 companies comprises of 749 group affiliated firms and 1253 standalone firms. We use panel regression models for empirical analysis, and the firms are removed if there is a missing observation in variables (in any of the year during the study period) to make the series a balanced panel.

8.2 Period of the study

In India, during the period 2013-2014, the corporate governance policies were revised, and some new policy measures were introduced. The Companies Act, 1956 are revised and the new Companies Act, 2013 came into force on 12th September 2013 with 98 provisions and later 184 sections came into force on 1st April 2014. The Companies Act, 2013 contains a detailed definition of related party and RPTs; the disclosure requirements and approval process of RPTs were also revised. To make corporate governance more effective the market regulator, SEBI revised their Clause, 49 of the listing agreement, which is applicable to all listed companies with effect from 1st October 2014. Similar to the Companies Act, 2013, the revised Clause 49 of the SEBI listing agreement also contains some improved measures for regulating RPTs. So it makes importance to measure the impact of new RPT regulations on the value of RPTs, Nature of RPTs; therefore our study covers a period of five years from 1st April 2012 to 31st March 2016. Most of the RPT related regulations came into force on 1st April 2014, so our sample covers three-years before the implementation of new regulations and two-year after the implementation of new RPT regulations.

8.3 Data collection

All the objectives of the study were analyzed using secondary data. The secondary data for empirical analysis have been collected from the Prowess database maintained by CMIE and the annual reports of the companies.

8.4 Variables used for the study

The following variables are used for empirical and descriptive analysis.

8.4.1 RPTs variables

8.4.1.1 Related Party Sales (RPS) – it represents income from the sale of goods to related parties.

8.4.1.2 Related Party Services (RPSS) – it is the income from services to related parties.

8.4.1.3 Other revenue receipts from related parties (RRP) – it includes all other revenue receipts such as rent income, interest income…etc.

8.4.1.4 Total Revenue Receipts from related parties (TRR) – it is the sum of all the revenue receipts from related parties such as RPS, RPSS, and RRP.

8.4.1.5 Related Party Purchases (RPP) – it is the amount paid for the purchase of goods and finished goods from related parties.

8.4.1.6 Revenue Expenses paid to related parties (RPRE) – it includes all other types of revenue payments to related parties such as salaries, wages, rent…etc.

8.4.1.7 Total Revenue Expenses paid to related parties (TRE) – it is the sum of RPP and RPRE.

8.4.1.8 Capital Receipts from Related Parties (CRRP) – it is the sum total of the amount received from related parties for the sale of assets and investments.

8.4.1.9 Capital Payments to Related Parties (CPRP) – it is the sum total of the amount paid to related parties for the purchase of capital assets and investments.

8.4.1.10 Related Party Borrowings (RPB) – it is the total of borrowings from related parties.

8.4.1.11 Loans and Advances to Related Parties (LARP) – it is the total loans and advances to the related parties.

8.4.1.12 Related Party Transactions (RPTs) – it is the sum total of different RPTs such as TRR, TRE, CRRP, CPRP, RPB, and LARP.

The various types of RPTs are reported Rupees in millions and for empirical analysis total amount of RPTs are scaled by the total assets. The types of RPTs such as TRR and TRE is considered as operating RPTs, and all other types of RPTs are considered as non-operating RPTs.

8.4.2 Variables used for measuring firm performance

This study examines the impact of RPTs on firm performance; both market-based performance measure and accounting based performance measure are used for empirical analysis.

8.4.2.1 Return on Assets (ROA)

8.4.2.2 Tobin's Q ratio

We use the following formula to calculate ROA and Tobin's Q ratio.

$$ROA = \frac{Profit\ before\ interest\ and\ tax}{Total\ Assets}$$

$$Tobin's\ Q = \frac{Market\ Value\ of\ Debt + Market\ Value\ of\ Equity}{Total\ Assets}$$

8.4.3 Measurement of Earnings Management

In accrual-based manipulations, the positive discretionary accrual is an indication of income increasing manipulations, and negative discretionary accrual is an indication of income decreasing manipulation. Dechow et al., (1995) developed a modified version of the Jones model to measure earnings management. Modified Jones model (Dechow, Sloan, & Sweeney, 1995) is one of the widely used models for the detection of earnings management. Mishra and Malhotra (2016), Kuntluru and Korivi (2016), Ajit, Malik and Verma (2013) Hwang, Chiou and Wang (2013), Chen, Cheng and Xiao (2011) and Jian and Wong (2010) used modified Jones model to investigate the relationship between RPTs and earnings management. Milko and Kamardin (2014) argue that the predictive power of the modified Jones model is very high compared to other accrual-based earnings management detection models. Following steps are followed to partition the discretionary component of accruals from the total accruals.

- Calculation of Total Accrual (TAC)

  $TAC_{I,t}$ = Reported operating income – operating cash flow

  Here $TAC_{i,t}$ is the value of total accruals of firm i during the year t. it is the difference between the firm's operating profit after tax and cash flow from operating activities.

- To adjust the differences in firm's size, all variables must be scaled by total assets at the end of the year t-1.

$$\frac{TAC_{it}}{TA_{i,t-1}} = \alpha_1 \frac{1}{TA_{i,t-1}} + \alpha_2 \frac{\Delta Sales_{it} - \Delta REC_{it}}{TA_{i,t-1}} + \alpha_3 \frac{PPE_{it}}{TA_{i,t-1}} + \varepsilon_{it}$$

$TAC_{i,t}$ = total Accrual of firm *i* in year *t.*

$TA_{i,t-1}$ = total Assets of firm *i* in year *t-1*.

$\Delta sales_{i,t}$ = change in sales revenue of firm *i* in year *t.*

$\Delta REC_{i,t}$ = change in receivables of firm *i* in year *t.*

$PPE_{i,t}$ = gross property, plant and equipment of firm *i* in year *t.*

$\varepsilon_{i,t}$ = error term.

To adjust the industry effect, the total observation is classified into two, manufacturing firms and non-manufacturing firms. The coefficient of α_1, α_2, and α_3 are estimated in each year by each group.

- Calculation of non-Discretionary Accruals (NDAC).

By using the estimated coefficient of α_1, α_2, and α_3, we calculated the non-discretionary accruals by using the following equation.

$$NDAC_{i,t} = \alpha_1 \frac{1}{TA_{i,t-1}} + \alpha_2 \frac{\Delta Sales_{it} - \Delta REC_{it}}{TA_{i,t-1}} + \alpha_3 \frac{PPE_{it}}{TA_{i,t-1}}$$

- Calculation of Discretionary Accruals (DA).

The discretionary accrual of each firm is estimated by subtracting the estimated non-discretionary accruals from total accruals.

$$DA_{i,t} = (TAC_{i,t} / TA_{i,t-1}) - NADCC_{i,t}$$

In this study, the discretionary accruals are estimated in each year by each industrial group. For the accrual estimation, the total Companies are grouped into 130 based on Prowess product code, the estimation of the coefficients of the Jones model in each industry increases the accuracy of the estimates.

8.4.4 Governance and ownership variables

In this study, we measured the system of governance and ownership by using the following variables.

8.4.4.1 Board Size (BS):

Size of the board represents the total number of directors on the board.

8.4.4.2 Board Independence (BI):

An independent director is a non-executive director of a company and who do not have any relationship with the company which may affect the independent position on the board.

8.4.4.3 Executive directors (BE):

Rule 2 (1) (K) of the companies rule, 2014 says that the executive director is a whole time director as defined in section 2 (94) of the Companies Act, 2013. He is a director and also considered as the full-time employee of the company. The proportion of executive directors on the board is used for analysis.

8.4.4.4 Promoter Director (PD):

Promoters are the investors in the company. Directors are the managers of the company, and they frame policies and plans for the benefit of the investors, and it is not necessary that promoters can be the managers of the company and they can be the members of the board of director. The proportion of promoters on the board is used for analysis

8.4.4.5 CEO-Duality (Duality):

CEO-Duality is the situation in which the same person holds both the position of the chairman of the board and Chief Executive Officer (CEO) of the company. It is measured in

the form of a dummy variable coded as 1 if the same person holds both the positions otherwise 0.

8.4.4.6 Promoters Holdings (PH):

The proportion of the promoters holding on the total issued equity capital is used to measure founder ownership.

8.4.4.7 Institutional Holdings (IH):

The IH represents the proportion of the equity holdings of the institutional investors on the total equity capital issued.

8.4.5 Other variables

We have used some variables in the regression analysis to control the relationship between variables. They are mentioned below.

8.4.5.1 Firm size (Size): the natural log of total assets is used to measure firm size.

8.4.5.2 Leverage (LEV): Firms' debt to total asset ratio is used as a measure of financial leverage.

8.4.5.3 Firm's Age (Age): the natural log of the number of years from which firm has been incorporated is the measure of firm age.

8.5 Econometric Models Developed for the Study

8.5.1 Determinants of RPTs: we developed a panel-Tobit model to investigate the determinants of RPTs. Some firms in the sample have not reported any type of RPTs during the study periods; therefore, the method of Tobit regression is used for estimating the coefficients.

$$RPTs = PH_{i,t} + IH_{i,t} + BS_{i,t} + BI_{i,t} + BE_{i,t} + PD_{i,t} + Duality_{i,t} + Size_{i,t} + LEV_{i,t} + Age_{i,t} + \varepsilon$$

Here RPTs, is the dependent variable it is the total amount of RPTs scaled by total assets and PH and IH are the measures of firm ownership, and other variables represent the board characteristics excluding Size, Lev and Age they are the controlled variables. $\varepsilon_{i,t}$ is the error term and have been assumed (0,1), i=1…, N, and t=1…T.

8.5.2 Firm performance and RPTs: We developed a panel regression model to measure the relationship between RPTs and firm performance. ROA is used as a measure of firm operating performance, and Tobin's Q ratio is used as a measure of the firm's market value.

$$ROA\ or\ Tobin'sQ = \alpha_0 + \alpha_1 RPS_{i,t} + \alpha_2 RPSS_{i,t} + \alpha_3 RPOPR_{i,t} + \alpha_4 RPP_{i,t} + \alpha_5 RPRE_{i,t} + \alpha_6 CRRP_{i,t} + \alpha$$

The variables such as PH, IH, Size, Lev, and Age were taken as the controlled variables; the subscript i represent firm and t represent the year.

8.5.3 Interaction effect of ownership and governance on RPTs and firm performance: we developed two-panel regression models, the first model examines the interaction effect of ownership characteristics on the relationship between RPTs and firm performance and the second model measure the interaction effect of governance characteristics on the relationship between RPTs and firm performance.

$$ROA\ or\ QRatio = \alpha_0 + \alpha_1 REG * RPTs_{i,t} + \alpha_2 PH * RPTs_{i,t} + \alpha_3 IH * RPTs_{i,t} + \alpha_4 PH_{i,t} + \alpha_5 IH_{i,t} + \alpha_6$$

$$ROA\ or\ QRatio = \alpha_0 + \alpha_1 BS * RPT_{i,t} + \alpha_2 BI * RPT_{i,t} + \alpha_3 BE * RPT_{i,t} + \alpha_4 PD * RPTs_{i,t} + \alpha_5 Dualit$$

8.5.4 RPTs and earnings management: we developed a panel regression model to measure the relationship between RPTs and earnings management where the absolute value of discretionary accruals are taken as a proxy of earnings management. The same model is also applied in the group affiliated firms and the standalone firms.

$$DACC = \alpha_0 + \alpha_1 TRR_{i,t} + \alpha_2 TRE_{i,t} + \alpha_3 CPRP_{i,t} + \alpha_4 CRRP_{i,t} + \alpha_5 RPB_{i,t} + \alpha_6 LARP_{i,t} + \alpha_7 BS + \alpha_8 BI_{i,t}$$

We run a pooled OLS regression assuming that there is no heterogeneity and we also run a panel fixed effect regression assuming that there is individual heterogeneity. The Wald-statistic is used to check whether a fixed effect or pooled OLS regression is appropriate, and we run panel random effect regression if there is an individual heterogeneity in the regression. We used Hausman-statistic to test whether a fixed effect or random effect model is appropriate.

9. Limitations of the Study

The researcher has perceived the following as the limitations of the study.

9.1 The study analyzed the RPTs of the selected non-financial firms in India, banking, and financial companies are excluded.

9.2 The total amount of RPTs is taken for empirical analyses; the frequency of RPTs is not considered.

9.3 The effect of RPTs in various regression analyses may change if the RPTs are classified according to the parties related to it.

9.4 Only a single measure of earnings management is used (Modified Jones model), and the real earnings management measures have not been considered in the empirical analysis.

10. Research Findings

The study made a detailed analysis of RPTs in India, the impact of RPTs on firm performance, and the effect of ownership and governance characteristics on RPTs. The findings of the analysis are listed below.

10.1 RPTs in India

10.1.1 More than 92 percent of the select companies reported various types of RPTs during the study period.

10.1.2 86 percent of companies have RPTs with KMPs, 33 percent of companies have RPTs with subsidiary 69 percent of the companies have RPTs with the parties where control exists, 28 percent of companies have RPTs with the relatives of KMP, and 8 percent of companies have RPTs with the holding companies.

10.1.3 More than 35 percent of the total values of RPTs are with subsidiary firms.

10.1.4 Based on the value of RPTs purchases from related parties and income from the sale of goods and services to related parties are the major types of RPTs in India.

10.1.5 CPRP and LARP are the major types of non-operating RPTs based on the value of transactions.

10.1.6 Operating RPTs such as RPS, RPSS, RPOPR, RPP, and RPRE constitute more than 75 percent of the total amount of RPTs with the parties where control exists.

10.1.7 More than 95 percent of the group affiliated firms have a business relationship with their related parties.

10.1.8 The mean differences of RPTs in group affiliated firms compared to standalone firms are positive and significant, which indicate that during the study period the level of RPTs in group affiliated firms is high compared to the standalone firms.

10.1.9 Out of the 1471 manufacturing firms, around 95 percent of firms have a business relationship with their related parties.

10.1.10 In service industries, around 87 percent of firms have business relationships with their related parties.

10.1.11 The mean difference of RPTs in manufacturing firms compared to service firms is negative, but they are statistically not significant, which shows that the magnitude of RPTs in manufacturing firms and service firms are the same.

10.2 Determinants of RPTs

10.2.1 PH has a positive impact on RPTs.

10.2.2 IH has a positive impact on RPTs.

10.2.3 The average PH in India during the study period is 0.53.

10.2.4 BS has a positive impact on RPTs.

10.2.5 BE has a negative impact on RPTs.

10.2.6 The dual role of the chairman is in favor of the firm's decision to engage RPTs.

10.3 RPTs and Firm performance

The empirical findings show that RPTs have a positive impact on firm performance, which indicate that the insiders of Indian firms do not use RPTs for tunneling and firms use RPTs to prop up their performance.

10.3.1 There is a positive association between RPTs and firm performance.

10.3.2 RPS RPSS, RPOPR, RPP, RPRE, and LARP have a positive association with firm performance.

10.3.3 There is a positive association between CRRP and firm performance in standalone firms.

10.3.4 There is a positive association between CPRP and firm performance in group affiliated firms.

10.4 Interaction effect of ownership and governance on the relationship between RPTs and firm performance:

10.4.1 PH has a positive interaction effect on the relationship between RPTs and firm performance.

10.4.2 REG has a positive interaction effect on the relationship between RPS and firm performance.

10.4.3 REG has a negative interaction effect on the relationship between CRRP and firm performance.

10.4.4 PH has a positive interaction effect on the relationship between RPS and firm performance.

10.4.5 PH has a positive interaction effect on the relationship between RPSS and firm performance.

10.4.6 PH has a positive interaction effect on the relationship between CRRP and firm performance.

10.4.7 PH has a positive interaction effect on the relationship between CPRP and firm performance.

10.4.8 IH has a positive interaction effect on the relationship between RPOPR and firm performance.

10.4.9 IH has a negative interaction effect on the relationship between RPSS and firm performance.

The literature also says that in addition to the ownership structure of the firm, the governance, especially board characteristics, have an impact on RPTs and effective governance mechanism can transform the abusive RPTs into efficient transactions. The

following are the empirical result of the role of governance mechanism on the relationship between RPTs and firm performance.

10.4.10 BS has a positive interaction effect on the relationship between RPOPR and firm performance.

10.4.11 BS has a negative interaction effect on the relationship between RPS and firm performance.

10.4.12 BS has a positive interaction effect on the relationship between CRRP and firm performance.

10.4.13 BI has a negative interaction effect on the relationship between RPSS and firm performance.

10.4.14 BI has a negative interaction effect on the relationship between RPOPR and firm performance.

10.4.15 BI has a positive interaction effect on the relationship between RPP and firm performance.

10.4.16 BI has a positive interaction effect on the relationship between LARP and firm performance.

10.4.17 BE has a positive interaction effect on the relationship between RPSS and firm performance in the full sample and standalone firms.

10.4.18 BE has a positive interaction effect on the relationship between CPRP and firm performance.

10.4.19 PD has a negative interaction effect on the relationship between CPRP and firm performance.

10.4.20 PD has a positive interaction effect on the relationship between RPB and firm performance.

10.4.21 Duality has a positive interaction effect on the relationship between RPSS and firm performance.

10.5 RPTs and firm value

The empirical findings show that RPTs have a positive impact on firm value, which indicate that the insiders of Indian firms do not use RPTs for tunneling and firms use RPTs to prop up their performance.

10.5.1 RPTs have a positive impact on firm value.

10.5.2 RPOPR has a positive impact on firm value.

10.5.3 RPRE has a positive impact on firm value.

10.5.4 RPB has a positive impact on firm value.

10.6 Interaction effect of ownership and governance on the relationship between RPTs and firm value:

10.6.1 REG has a positive interaction effect on the relationship between operating RPTs and firm value.

10.6.2 IH has a positive interaction effect on the relationship between RPTs and firm value.

10.6.3 IH has a positive interaction effect on the relationship between RPS and firm value.

10.6.4 IH has a positive interaction effect on the relationship between RPP and firm value.

10.6.5IH has a positive interaction effect on the relationship between CPRP and firm value.

10.6.6 IH has a negative interaction effect on the relationship between RPSS and firm value.

The literature says that the governance mechanism has a significant influence on RPTs and the nature of RPTs. We examined the interaction effect of governance mechanism on the relationship between RPTs and firm value. The findings are listed below.

10.6.7 BS has a positive interaction effect on the relationship between RPOR and firm value.

10.6.8 BS has a positive interaction effect on the relationship between RPP and firm value.

10.6.9 BS has a positive interaction effect on the relationship between RPB and firm value.

10.6.10 BI has a negative interaction effect on the relationship between RPOPR and firm value.

10.6.11 BI has a positive interaction effect on the relationship between RPP and firm value.

10.6.12 BE has a positive interaction effect on the relationship between RPSS and firm value.

10.6.13 BE has a positive interaction effect on the relationship between CPRP and firm value.

10.6.14 PD has a negative interaction effect on the relationship between CPRP and firm value and a positive interaction effect on the relationship between RPB and firm value.

10.6.15 Duality has a positive interaction effect on the relationship between RPSS and firm value and the relationship between RPP and firm value.

10.6.15 Duality has a positive interaction effect on the relationship between RPSS and firm value and the relationship between RPRE and firm value in standalone firms.

10.7 RPTs and Earnings Management

10.7.1 In India, most firms engage in income decreasing manipulations.

10.7.2 The average accrual based earnings management of Indian firms is more than 8 percent of the total assets.

10.7.3 4935 firm-year observations represent income increasing manipulations, and 5075 firm-year observations represent income decreasing manipulations.

10.7.4 The average earnings management in group affiliated firms is 7 percent of the total assets, which is less than the average of the full sample.

10.7.5 The average of the earnings management in standalone firms is more than the average of the full sample.

10.7.6 There is no statistically significant mean difference of DACC in group affiliated firms compared to standalone firms.

10.7.7 The mean difference of various earnings management measures such as Abs DACC, positive DACC, and negative DACC are statistically different in group affiliated firms compared to standalone firms.

10.7.8 There is a positive association between TRE and earnings management.

10.7.9 RPB has a positive association with income decreasing manipulations.

11. Suggestions

According to the findings of the study, we have the following suggestions to the regulators and various stakeholders.

11.1 Clause 49 of the SEBI listing agreement and Companies Act 2013 mandate the disclosure of RPTs such as parties relating to the reporting entity, value of transactions and the method of transfer pricing...etc. There is no uniformity of companies in the disclosure of RPTs, and only a few companies have a policy on RPTs. Therefore the regulators take effective policy measures to bring a uniform disclosure policy on RPTs.

11.3 The results show that based on the value of RPTs operating RPTs are the major types of RPTs in India and there are positive relations between RPTs and firm performance; therefore the regulators should remove the policy barriers if exists which are against the business dealings between the affiliated firms. The audit committee approval and shareholder approval may cause the time lag of the transactions between parties and which may unfavorably affect the transfer of resources at the right time.

11.4 The empirical results of the determinants of RPTs show that BI has a negative effect on the value of RPTs. The regulators need to be checked the attitude of outside directors against RPTs even though RPTs have a positive impact on firm performance.

11.5 The impact of BE on the value of RPTs need to be checked because the presence of internal directors on the board act against the RPTs even though RPTs are positively associated with firm performance.

11.6 The regulators make control over the founder directors and their involvement in the decisions relating to RPTs because there is a negative interaction effect of PD on the relationship between CPRP and firm performance.

11.7 The empirical pieces of evidence on the association between RPTs and earnings management make into the attention of regulators that even though RPTs in India is not harmful, they are used for earnings management. So effective policy measures are required to control the manipulation via RPTs.

11.8 The earnings management literature shows that most firms engage in income decreasing manipulations, and TRE is used as a tool for this manipulation. This kind of manipulations and its reasons needs to be examined.

12. Conclusion

The transaction efficiency hypothesis and conflict of interest hypothesis increase the complexity of RPTs. The descriptive statistics of RPTs in India reported in chapter 5 show that most companies in India have various types of business relationship with their related parties, This study focused on a detailed examination of RPTs in India, the impact of RPTs on firm performance and market value and the association between RPTs and earnings management.

This study shows that operating RPTs such as related party sales, purchases from related parties...etc are the major types of RPTs based on the value of transactions and subsidiary firms are major types of related parties in India. The descriptive analysis of RPTs in India also show RPTs are very high in group affiliated firms compared to the standalone firms and RPTs are very high in service firms compared to the manufacturing firms based on the value of transactions.

The empirical analysis based on a sample of 2002 Companies shows that governance and ownership characteristics have an impact on the value of transactions. PH, IH, BS, and CEO-Duality have a positive impact on the value of RPTs, and the results also show that apart from these relationships BI and BE have a negative impact on the value RPTs excluding subsidiary firms. These results indicate that higher promoter ownership and institutional ownership are in favor of the decision to engage RPTs, but a board with more number of independent directors and executive directors act against the decision to engage RPTs. In short, the empirical findings prove that the internal governance mechanism and ownership characteristics have an impact on the value of RPTs. The empirical pieces of evidence on the association between RPTs and firm performance show that RPTs have a positive impact on firm operating performance and the relationship is very strong on the association between

operating RPTs and firm performance. The research results support the new RPT regulations implemented in the year 2014 due to its positive interaction effect on the association between RPTs and firm performance. The findings of the study also say that governance and ownership characteristics have an interaction effect on the association between RPTs and firm performance. The interaction effect of the ownership and board characteristics on the relationship between RPTs and firm performance depends upon the nature of transactions. RPTs have a similar positive impact on both market based and accounting-based measures of firm performance and in both the cases, the governance and ownership characteristics have an interaction effect on the association between RPTs and firm performance. Our findings show a positive association between RPTs and earnings management and based on the types of RPTs, TRE is used for income decreasing manipulations.

The results of the study show that most firms in India have various types of business dealings with their related parties, and RPTs in India have a positive impact on firm performance. The governance and ownership characteristics have an impact on the value of RPTs, and they have an interaction effect on the association between RPTs and firm performance. The findings of the study are useful to investors and policymakers. The results show that the minority shareholders are safe from the expropriation of controlling shareholders via abusive RPTs, and the existing RPT regulations are effective to control abusive RPTs.

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Workshops and Seminars Attended

1. Participated a one-month national workshop on econometrics organized by Department of Commerce and Management Studies (DCMS), Farook College (Autonomous), Calicut, Kerala from 04/04/2016 to 30/04/2016.
2. Participated in a six days workshop on 'International Financial Reporting Standards' organized by Department of Commerce and Management Studies (DCMS), University of Calicut, Kerala, from 20th June 2016 to 25th June 2016.
3. Participated a GIAN Course titled "Flexible Statistical Modeling" held at the Department of Statistics, Mangalore University, from 10th October to 14th October 2016.
4. Attended the faculty development program titled "Multivariate Data Analysis using SPSS and AMOS- A Publication focus" organized by T.A. PAI Management Institute, Manipal. Held between 2nd and 4th February,2017.
5. Participated a one day workshop on "Planning and Writing a research paper" organized by Department of Commerce and Management Studies (DCMS), University of Calicut on 25th and 26th March, 2017.
6. Participated the national workshop on "Advanced Topics in Econometrics" held at The Zamorins'Guruvayurappan College, Calicut. From 24th to 27th of April 2017.
7. Participated in the international conference on "corporate Governance and Emerging Trends" organized by Department of Commerce and Management Studies (DCMS), University of Calicut. Held on 7th and 8th June, 2017.
8. Attended a five-day national level workshop on "Econometrics Tools for Business Research" Organized by school of Management Studies, Pondicherry University. From 19 to 23 June, 2017.

9. Participated in the GIAN course “Statistical Analysis of Big Data Using R” conducted by the Department of Statistics, Mangalore University during 03rd December to 8th December 2018.
10. Participated in the GIAN course “Digital payments: Technology for Cashless Society” conducted by the Department of Computer Science, Mangalore University, from 23rd to 27th July 2018.
11. Participated a one month Workshop on “Econometrics” organized by the Department of Commerce and Management Studies, Farook College, Calicut, Kerala from 2nd to 30th May, 2018.